

Message Text

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TO AMEMBASSY TOKYO PRIORITY

C O N F I D E N T I A L STATE 119485

E.O. 11652: GDS

TAGS:

SUBJECT: JAPAN - POSSIBLE IMPOSITION OF RESERVE REQUIREMENTS ON FOREIGN CURRENCY LIABILITIES OF BANKS

REF: TOKYO 6847

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1. THE TREASURY AND FEDERAL RESERVE HAVE REVIEWED THE JAPANESE PROPOSAL REPORTED IN REFTEL. WE RECOGNIZE AND APPRECIATE THAT THE PROPOSAL COULD RESULT IN A DESIRABLE EASING OF EXCHANGE CONTROLS, BUT WOULD NOTE THAT IF RAISED TO PUNITIVE LEVELS THE RESERVE REQUIREMENTS MIGHT HAVE A DISCRIMINATORY IMPACT ON JAPANESE BRANCHES OF U.S. BANKS.

2. ACCORDINGLY, EMBASSY MAY DRAW UPON THE FOLLOWING

TALKING POINTS TO DISCUSS OUR CONCERN WITH THE APPROPRIATE JAPANESE AUTHORITIES AND TO REQUEST THAT CONSIDERATION BE GIVEN TO POSSIBLE REMEDIAL MEASURES:

- (A) THE EXPECTED PARTIAL LIBERALIZATION OF FOREIGN EXCHANGE CONTROLS IS A STEP IN THE RIGHT DIRECTION.
- (B) FURTHERMORE, IN PRINCIPLE, THE SUBSTITUTION OF MODEST RESERVE REQUIREMENTS ON FOREIGN CURRENCY LIABILITIES FOR THE EXISTING FOREIGN EXCHANGE CONTROLS REPRESENTS A DESIRABLE SHIFT TOWARD THE USE OF MARKET-ORIENTED POLICY INSTRUMENTS AND AWAY FROM ADMINISTRATIVE RESTRAINTS.
- (C) NEVERTHELESS, WE ARE CONCERNED THAT THE IMPOSITION OF RESERVE REQUIREMENTS ON BANKS' FOREIGN CURRENCY LIABILITIES MIGHT HAVE A SERIOUS ADVERSE IMPACT ON THE BRANCHES OF FOREIGN BANKS (ESPECIALLY OF U.S. BANKS) DUE TO THEIR GREATER RELIANCE THAN DOMESTIC JAPANESE BANKS ON FOREIGN CURRENCY LIABILITIES TO FINANCE THEIR LENDING IN JAPAN. THIS DIFFERENTIAL PATTERN OF FINANCING, WHICH ARISES IN PART FROM JAPANESE RESTRICTIONS ON ACCESS TO YEN FUNDS, COULD RESULT IN UNWARRANTED HARSHSHIP FOR FOREIGN BANKS SHOULD THE RESERVE REQUIREMENTS ON FOREIGN LIABILITIES EXCEED THOSE ON DOMESTIC DEPOSITS.

- (D) TO THE GREATEST EXTENT PRACTICABLE, U.S. AUTHORITIES HAVE APPLIED THE PRINCIPLE OF NATIONAL TREATMENT TO

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FOREIGN BANK OPERATIONS IN THE U.S. THUS, JAPANESE BANKS IN THE U.S. HAVE ACCESS TO LOCAL CURRENCY FUNDS. FURTHERMORE, SPECIAL PROVISIONS WERE MADE IN U.S. VOLUNTARY RESERVE REQUIREMENTS ON FOREIGN LIABILITIES TO TAKE ACCOUNT OF THE GREATER DEPENDENCE OF U.S. BRANCHES OF FOREIGN BANKS ON THEIR HEAD OFFICES FOR FUNDS.

- (E) IN VIEW OF THE POTENTIAL DISCRIMINATORY EFFECTS ON BRANCHES OF FOREIGN BANKS OF THE PROPOSED ARRANGEMENTS, SOME PROVISION SHOULD BE MADE FOR AMELIORATING THEIR IMPACT.

3. THE FOLLOWING INFORMATION ON U.S. RESERVE REQUIREMENTS IS PROVIDED FOR THE EMBASSY'S BACKGROUND AND MAY BE DRAWN UPON IN YOUR DISCUSSIONS WITH JAPANESE OFFICIALS.

THE FEDERAL RESERVE CURRENTLY IMPOSES A 4 PERCENT RESERVE REQUIREMENT ON NET BORROWING BY U.S. BANKS FROM THEIR FOREIGN BRANCHES, AND ON LOANS FROM FOREIGN BRANCHES TO U.S. RESIDENTS SINCE THE LATTER COULD SERVE AS A SUBSTITUTE FOR HEAD OFFICE BORROWING FROM BRANCHES. IN

ADDITION, CHAIRMAN BURNS' LETTER OF JUNE 1, 1973 REQUESTED THE U.S. OFFICES OF FOREIGN BANKS VOLUNTARILY TO HOLD RESERVES AGAINST INCREASES IN THEIR NET LIABILITIES TO THEIR HEAD OFFICES ABOVE THEIR OUTSTANDING POSITION IN MAY 1973. THIS REQUEST TO U.S. OFFICES OF FOREIGN BANKS ESTABLISHED PARALLEL TREATMENT WITH U.S. BANKS. FURTHERMORE, FOREIGN BANKS WERE AFFORDED A RESERVE-FREE BASE IN RECOGNITION OF THEIR DEPENDENCE ON THEIR HEAD OFFICE FOR FUNDS, AND ALSO OF THE FACT THAT THE BOARD WAS ESTABLISHING A MARGINAL RESERVE REQUIREMENT ON LARGE CD'S ISSUED BY MEMBER BANKS.

THE U.S. RESERVE REQUIREMENTS ON FOREIGN LIABILITIES WERE DESIGNED TO PROMOTE COMPETITIVE EQUITY BETWEEN BANKS WITH AND WITHOUT FOREIGN BRANCHES IN DOMESTIC
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BANKING BY ELIMINATING A SOURCE OF RESERVE-FREE FUNDS FOR THE LARGE BANKS WITH FOREIGN BRANCHES. IN PAST PERIODS THE RESERVE REQUIREMENTS ALSO HAVE BEEN USED AS A MEASURE TO INFLUENCE FLOWS THROUGH BANKS; HOWEVER, THE EFFECTIVENESS OF THOSE ACTIONS HAS BEEN UNCERTAIN BECAUSE U.S. MONEY MARKET CONDITIONS SHIFTED SHORTLY AFTER THE IMPOSITION OF THESE REQUIREMENTS.

MORE BROADLY, THE ABILITY OF AUTHORITIES TO CONTROL CAPITAL FLOWS THROUGH RESERVE REQUIREMENT MEASURES DEPENDS ON THE AVAILABILITY OF OTHER CHANNELS FOR SUCH FLOWS. THUS, THE JAPANESE AUTHORITIES MAY FIND THEIR PROPOSED MEASURES INEFFECTIVE AS AN INSTRUMENT TO COMBAT SPECULATIVE CAPITAL MOVEMENTS AND TO INSULATE DOMESTIC MONETARY POLICY. THIS COULD BE THE CASE IF IMPOSITION OF RESERVE REQUIREMENTS ON THE FOREIGN LIABILITIES OF JAPANESE BRANCHES OF U.S. BANKS LED THE U.S. BANKS TO LEND FROM THEIR OFFICES OUTSIDE JAPAN TO JAPANESE COMPANIES OR TO FOREIGN SUBSIDIARIES OF JAPANESE COMPANIES.
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